Insights: Alerts

DOL Opens ESG Door: What Does It Mean for Plan Fiduciaries?

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Department of Labor ("DOL") Secretary Walsh recently announced final regulations in a blog post titled "Removing Barriers to Considering ESG Factors in Retirement Plan Investments." While the rules open the door to more employer retirement plans taking into account environmental, social, and governance ("ESG") factors in investment decisions, fiduciaries still need to be careful to ensure that their fiduciary processes reflect appropriate consideration of ESG factors. The new rules also address how fiduciary standards apply to voting proxies and exercising other shareholder rights with respect to plan investments.

As ESG investing has grown in popularity, it has attracted controversy. The Securities and Exchange Commission ("SEC") has adopted an "all-agency" approach to ESG disclosures.[1] The controversies have been particularly pronounced in the context of public pension funds, which are not subject to the fiduciary duties of ERISA. On August 4, 2022, nineteen Republican state attorneys general signed a letter accusing Blackrock of breaching duties of loyalty and prudence in managing state pension funds and violating antitrust laws as a result of its support of carbon neutrality.[2] (Blackrock denied these claims in a response released in September.[3]) On December 1, 2022, the CFO for the state of Florida announced that the Florida State Treasury would begin divesting $2 billion from Blackrock.[4]

Given the political controversy, any expansion of ESG investing into 401(k) plans and private pension plans can be expected to be controversial. While the new regulations are intended to level the playing field for ESG investing, they provide no safe harbors for retirement plan fiduciaries. As a result, fiduciaries will need to carefully document prudent fiduciary processes regardless of whether they are specifically considering investment strategies or decisions that involve ESG factors.

I. Procedural History

On December 1, 2022, the DOL published a final regulation addressing the standards that apply to investments that consider ESG factors ("ESG Regulations"). The ESG Regulations largely follow proposed regulations that were released on October 14, 2021 (previously discussed here and here) ("Proposed Rule") but marks a departure in several respects from a Trump administration rule addressing the same topic ("2020 ESG Regulations"). The ESG Regulations also replace a separate Trump administration rule relating to proxy voting by retirement plans ("2020 Proxy Regulations", and, collectively with the 2020 ESG Regulations, the "2020 Regulations").

The ESG Regulations are generally effective with respect to investment decisions that are made after January 30, 2023, although two provisions relating to proxy voting are not effective until one year after publication.[5] As discussed in our prior blog post, the Biden administration issued an indefinite nonenforcement policy with respect to the 2020 Regulations shortly after taking office, pending finalization of revised rules. However, the non-enforcement policy does not preclude courts from considering the 2020 Regulations in connection with fiduciary breach claims brought by participants (for example, in the context of class action litigation). In addition, ERISA plan fiduciaries continue to be held to general standards of prudence and loyalty with respect to ESG investment and proxy voting under the non-enforcement policy until the ESG Regulations take effect.

II. ESG Factors in Investment Decisions

A. Overview

The DOL recognizes that ESG investing can take several forms. This can include "negative screening," where investments that score poorly based on ESG factors are excluded (e.g., carbon emissions) or "positive screening", where investments are selected because they score highly on ESG factors (e.g., sustainability). ESG investing can also involve an "integrated" approach, where ESG factors are incorporated into a broader investment analysis.[6] In any of these forms, ESG investing implicates two primary fiduciary duties under ERISA:

> **Duty of Prudence**. The duty of prudence would be violated if fiduciaries sacrifice investment return or take on additional risk for participants by selecting investments based on ESG factors.
>
> **Duty of Loyalty**. The duty of loyalty would also be violated if fiduciaries select investments due to collateral benefits (such as ESG policies) that are important to the fiduciaries at the expense of the investment return of the plan.

The DOL has long recognized that taking ESG factors into account in investment decisions does not necessarily violate these fiduciary duties. Under longstanding principles, taking ESG factors into account for investments may be appropriate (i) when the fiduciary prudently determines that the ESG factors are material to the risk/return characteristics of an investment, and (ii) when the fiduciary determines that alternative investments may be materially equivalent from a risk/return perspective and the fiduciary uses ESG factors as a tie-breaker.[7]

However, the DOL has issued inconsistent guidance over the years as to how these principles are applied. The DOL under the current administration views the 2020 Regulations as having a "chilling effect" on the use of ESG factors.[8] The DOL characterizes the new ESG Regulations as intending to achieve "regulatory neutrality," such that ESG factors should be considered when relevant to risk/return, but their consideration is not mandated in all circumstances.[9] In this regard, the final ESG Regulations omitted language from the Proposed Regulations saying that evaluating the risk/return of particular investments "may often require an evaluation of the economic effects of climate change and other environmental, social, or governance factors on the particular investment or investment course of action."[10] In addition, the final ESG Regulations omitted a list of examples of ESG factors[11] that may be relevant to investment decisions so that they would not be misconstrued as mandatory for consideration in all circumstances or as a safe harbor or exclusive list of factors that should be considered.

Instead, the ESG Regulations impose a standard that a fiduciary must take into account any factors that it knows, or should know, are relevant to the particular investment, which may include ESG factors depending on the individual facts and circumstances.[12] Further, "the weight given to any factor by a fiduciary should appropriately reflect a reasonable assessment of its impact on risk-return."[13] This requirement is almost identical to language from the 2020 Regulations requiring a "prudent assessment" of ESG factors on risk/return.[14]

Accordingly, the ESG Regulations do not soften the burden on plan fiduciaries in assessing whether ESG factors would affect investment risk/return. Fiduciaries will need to ensure that their assessments are well-grounded. In this regard, the DOL addressed the questions that many experts have raised questions about the reliability of ESG rating agencies by saying that it anticipates that "fiduciaries will give the same careful consideration to the usefulness of data sources pertaining to ESG as they do to any relevant data source."[15]

> ***Takeaway***: Fiduciaries must come to their own conclusions (with assistance from their investment advisers) as to whether, which, and how ESG factors should be considered as part of the risk/return characteristics of an investment.

B. Fiduciary Documentation of ESG Considerations

The new ESG Regulations eliminate a special documentation requirement that would have applied under the 2020 ESG Regulations when a fiduciary applies ESG factors as a tie-breaker between otherwise equivalent investments. Fiduciaries would have been required to maintain documentation in cases of a tie-breaker showing: (i) why financial factors were not sufficient to distinguish the investments, (ii) how the investments compared in terms of relevant factors, and (iii) how the ESG factors applied are consistent with the interest of participants and beneficiaries.[16] The DOL found that this special documentation requirement could be viewed as a "red flag" that applying ESG factors is problematic, even when used appropriately, and could increase litigation risks and "discourage proper fiduciary activity and transparency."[17] However, the preamble notes that "the removal of this provision does not excuse ERISA fiduciaries from the documentation required to satisfy their general prudence obligations."[18]

Appropriate documentation of a prudent fiduciary process is essential to all fiduciary decisions, regardless of whether ESG factors have been applied in making investment decisions. As noted above, the ESG Regulations take a neutral approach to determining what factors are relevant to investment decisions. As a result, there is no checklist of factors that a fiduciary must consider, nor is a fiduciary excused from considering any factors that the fiduciary "should know" are relevant to risk/return of a particular investment.

In the preamble to the ESG Regulations, the DOL notes that a fiduciary "remains free under the final rule to determine that an ESG-focused investment is not in fact prudent."[19] However, for a fiduciary to *determine* that an ESG investment is not prudent, the fiduciary would have to first *consider* whether the investment is prudent and should document that process. Of course, it would not be possible to document why the universe of ESG factors are or are not relevant to the investment decision. But this underscores the importance of rigorously documenting what factors are relevant in investment decision-making.

When plan fiduciaries engage investment managers, they should evaluate the investment manager's processes for applying ESG factors. This includes investment managers that are responsible for a plan's entire portfolio of investments as well as investment managers with responsibility for a plan asset fund or a separate account.

This should include a review of how the ESG factors are considered and what support the investment manager has identified in determining that that the ESG factors applied are relevant to investment risk/return and do not sacrifice investment return or take on excess risk for the plan.

> ***Takeaways***: Proper documentation of the fiduciary process is essential in showing prudence. Fiduciaries should work with their investment advisers to ensure that their processes regarding ESG factors are appropriately documented. When engaging investment managers, fiduciaries should review their processes for applying ESG factors and regularly monitor their performance in accordance with the ESG Regulations.

C. ESG Funds in 401(k) Plans and Other Defined Contribution Plans

ESG investing in a 401(k) plan or other defined contribution plan where participants direct their investments raises special issues for fiduciaries compared to defined benefit plans. The risks of ESG investing in defined contribution plans are much greater for plan fiduciaries because they may be subject to class action litigation alleging that an available investment option was not prudent. In contrast, the Supreme Court has limited the ability of participants to bring actions over investment decisions in defined benefit plans unless the participant can show a loss of benefit, which may not occur absent special circumstances, such as the plan becoming severely underfunded or terminated without being fully funded.[20]

1. *ESG Funds as Investment Options*

The ESG Regulations recognize that there is a difference between ESG funds offered as investment options in a 401(k) plan (or other plan with participant-directed investments) and in a defined benefit pension plan. An ESG fund could be added to the investment menu in addition to a comparable non-ESG fund, so there may be no need for a tie-breaker.[21] Also, participants would be invested in an ESG fund only if they make the decision to invest in the fund. (Different considerations may apply in the context of default investment options, as addressed under "Default Investments" below.) The DOL also believes that offering ESG funds may potentially lead to increased retirement savings by participants because the available investment options may be better aligned with their interests.[22]

The ESG Regulations provide a couple of modifications to the fiduciary standards that may promote the use of ESG funds as investment options:

Duty of Loyalty. Fiduciaries do not violate the duty of loyalty by taking into account participant preferences in constructing an investment menu as long as the duty of prudence is satisfied.[23] However, the DOL cautioned that "fiduciaries may not add imprudent investment options to menus just because participants request or would prefer them."[24] Further, the ESG Regulations do not *require* fiduciaries to take into account participant preferences in constructing the investment menu.[25]

Duty of Prudence. Fiduciaries may take into account whether including an investment option in an investment menu may "further the purposes of the plan."[26] This may allow fiduciaries to take into account that adding ESG funds to a lineup could encourage employees to enroll or increase their savings rate.

However, fiduciaries should be careful to ensure that any ESG fund offered as an investment option has been properly evaluated and determined to be a prudent fund for the plan. The Supreme Court has emphasized that

fiduciaries have a duty to ensure that each investment option included in the investment menu is prudent and that it is not a defense that better options were available to participants.[27]

Further, the ESG Regulations require that fiduciaries evaluate the risk/return characteristics of each investment option "compared to the opportunity for gain (or other return) associated with reasonably available alternatives with similar risks."[28] This suggests that ESG funds should be compared to similar non-ESG funds that are available to ensure that they do not sacrifice investment return or take on additional risk compared to other available options.

> ***Takeaway***: The ESG Regulations may increase the popularity of ESG funds part of an investment menu, but fiduciaries should consider: (i) ensuring that the investment menu includes non-ESG funds so that participants have a real choice as to whether to invest in an ESG fund; and (ii) selecting and monitoring any ESG funds by comparing their risk and return characteristics to non-ESG funds.

2. *Default Investments*

The ESG Regulations repeal a complete ban on including any ESG fund or product as part of a qualified default investment alternative ("QDIA") that was instituted by the 2020 ESG Regulations. The ban was part of the DOL's assessment that QDIAs should be treated differently from other investment options because, although participants are deemed responsible for investments in the QDIA, they have not affirmatively elected the QDIA as an investment option. This ban applied to any fund "if its investment objectives or goals or its principal investment strategies include, consider, or indicate the use of" any non-financial factors.[29]

Accordingly, a fund would be prohibited from use as a QDIA if its managers employed any ESG strategies, even if the plan fiduciaries selected the fund purely based on financial criteria (without consideration of ESG factors). The DOL noted that this ban may be inconsistent with fiduciary duties because it could require a non-ESG fund to be selected as a QDIA even though a more-prudent ESG fund is available.[30]

While the ESG Regulations no longer ban ESG funds as QDIAs, fiduciaries should proceed very cautiously in selecting a QDIA. The DOL reiterated that it "continues to believe as a general matter that special protections may be needed in some contexts for plans containing these investments…"[31] The DOL did not include any other "special protections" for QDIAs in the ESG Regulations, but it is possible that fiduciaries who select ESG funds as a QDIA may be subject to special scrutiny.

> ***Takeaway***: The ESG Regulations remove the ban on ESG funds as a QDIA, but the DOL believes that QDIAs should be subject to special protection. Fiduciaries should be wary of selecting an ESG fund as a QDIA given that: (i) participants are invested in QDIAs by default rather than by their investment decisions, and, as a result, (ii) QDIAs tend to attract much larger investments than other investment options.

3. *Participant Disclosures*

The ESG Regulations did not include a provision in the Proposed Regulations that would have required prominent disclosures of ESG characteristics for any investment option that was selected on account of its collateral benefits as a tie-breaker. The DOL found that this disclosure would have been unnecessary and unhelpful. The existing participant disclosure notices already require descriptions of the investment strategies of

investment options, which should include descriptions of any ESG strategies, so it was not clear what additional disclosures would be required or how they would be helpful to participants.[32]

Further, this disclosure requirement would have applied only in the event that plan fiduciaries used ESG factors as a tie-breaker and not when ESG factors were applied solely in evaluating the fund's risk-return characteristics. As a result, this disclosure would have given participants only limited insight into the risk and return characteristics of investment options, and instead emphasized an aspect of the fiduciary process which may have been a red flag for potential litigation.[33] Accordingly, the DOL concluded that this disclosure requirement would not have been helpful to participants and may have had a chilling effect on offering ESG funds.

The DOL also noted that the SEC has initiatives in process regarding ESG investments with the intent of creating consistent standards that are not misleading. The DOL confirmed that it is monitoring these developments to determine if further disclosures should be required.[34] For example, the DOL may need to revise its regulations to extend any SEC disclosure rules for registered mutual funds with ESG strategies to other investment options in a 401(k) plan that are not subject to SEC regulation, such as collective investment trusts (CITs).

> ***Takeaway***: While the DOL has not required special disclosures for ESG funds, fiduciaries should review plan communications to ensure that they appropriately inform participants of any ESG strategies and are not misleading.

III. Proxy Voting

The DOL wants to avoid creating "a misperception that proxy voting and other exercises of shareholder rights are disfavored or carry greater fiduciary obligations, and therefore greater potential liability, than other fiduciary activities".[35] As a result, the ESG Regulations generally simplify the 2020 Proxy Regulations by eliminating a number of specific monitoring and recordkeeping requirements and safe harbors, in favor of more generic statements of the fiduciary duties that apply to the exercise of proxies and other shareholder rights.

The 2020 Proxy Regulations would have created two safe harbors fiduciary duties could be satisfied by policies under which (1) proxy voting would be limited to proposals that fiduciaries determined were substantially related to the issuer's business activities or were expected to have a material effect on the value of the investment, or (2) fiduciaries would refrain from voting proxies on proposals when the plan's holding in a single issuer relative to the plan's total investment assets was below a quantitative threshold. The DOL eliminated these safe harbors because it felt that they did not adequately safeguard participant interests.

The DOL also eliminated a requirement that fiduciaries maintain records regarding the exercise of proxies and other shareholder rights. The DOL explained its reasoning in the preamble, clarifying that it believes prudent fiduciaries are required to document fiduciary activities generally, which would generally include keeping accurate records of proxy voting activities that are sufficiently specific to permit fiduciaries to review periodically both the proxy voting policy that is being employed and the actions taken by an investment manager pursuant to that policy in individual cases.

The DOL also deleted language indicating that fiduciaries are not required to vote "every proxy" because the DOL felt it "could be misread as suggesting that plan fiduciaries should be indifferent to the exercise of their

rights as shareholders, particularly in circumstances where the cost is minimal as is typical of voting proxies."[36] The DOL clarifies its belief that proxies should generally be voted absent a good reason:

> The Department's longstanding view of ERISA is that proxies should be voted as part of the process of managing the plan's investment in company stock unless a responsible plan fiduciary determines voting proxies may not be in the plan's best interest (e.g., in cases when voting proxies may involve exceptional costs or unusual requirements, such as in the case of voting proxies on shares of certain foreign corporations).[37]

The DOL further clarified its belief the exercise of other shareholder rights, such as decisions on corporate actions like stock splits, tender offers, exchange offers on bond issues, and mergers and acquisitions, is just as important as proxy voting.

Instead of abstaining from proxy votes, the DOL suggests that costs may be controlled by relying, where possible, on "efficient structures" such as proxy advisory firms. However, the DOL stresses that these firms may not be relied on blindly—instead, fiduciaries must prudently vet and monitor their performance just as with any other service provider (assessing qualifications, quality of services, reasonableness of fees, whether guidelines align with plan goals, whether guidelines are being followed, etc.).[38] A prudent process should also be designed to avoid conflicts of interest. The DOL suggests in particular that prudent fiduciaries consider disclosures that are required to be provided by proxy advisory firms pursuant to SEC rules.

> ***Takeaways***: The DOL believes proxies should be voted (and other shareholder rights should be exercised) unless there is a good reason not to vote them, but participants' interests can be poorly served by excessive documentation and proxy research, so a balance must be struck. Fiduciaries may control costs by relying on proxy voting or advisory firms, but they must be prudently selected and monitored. The decisions of which rights to exercise and how (and which firms to retain or rely on in connection with that process) should be carefully documented to minimize fiduciary risks.

Conclusion

The new ESG Regulations are likely to spur an increase in ESG investments in employer retirement plans, but they come with risk for plan fiduciaries. Fiduciaries remain subject to demanding expectations to rigorously vet on a risk-return basis all investments that will be offered under a plan's investment menu, and the ESG Regulations do not provide any safe harbors. ESG factors should be considered in that analysis to the extent that they are relevant and may be considered in the event of a tie. Above all, fiduciary decisions relating to the consideration of ESG factors (and the use of ESG advisory firms) should be carefully considered and appropriately documented. Finally, fiduciaries should keep in mind that this area of regulation has been fluid since at least 2008, and so these regulations may not be the last say on the matter.

Footnotes

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[1] *See* https://www.sec.gov/sec-response-climate-and-esg-risks-and-opportunities.

[2] *See* https://www.texasattorneygeneral.gov/news/releases/ag-paxton-demands-blackrock-account-its-underperforming-potentially-illegal-esg-state-pension-fund.

[3] The Blackrock response is available at: https://www.blackrock.com/us/individual/literature/press-release/blackrock-response-attorneys-general.pdf.

[4] *See* https://www.myfloridacfo.com/news/pressreleases/details/2022/12/01/cfo-jimmy-patronis-florida-treasury-divesting-from-blackrock.

[5] *See* 87 Fed. Reg. 73886 (2022).

[6] *See* 87 Fed. Reg. at 73861.

[7] *See, e.g.,* IB 94-1; IB 2015-01; 87 Fed. Reg. at 73824.

[8] *See* 87 Fed. Reg. at 73877.

[9] *See* 87 Fed. Reg. at 73831.

[10] *See* Prop. Reg. 29 CFR § 2550.404a-1(b)(2)(ii)(C), 86 Fed. Reg. 57272, 57302 (2021).

[11] *See* Prop. Reg. 29 CFR § 2550.404a-1(b)(4), 86 Fed. Reg. at 57302. Factors included climate-change-related factors (such as a corporation's exposure to economic effects from climate change or from governmental regulation addressing climate change), corporate governance factors (such as board composition, executive compensation and transparency), and workforce practices (such as diversity, inclusion, and labor relations).

[12] *See* 29 CFR § 2550.404a-1(b)(i).

[13] 29 CFR § 2550.404a-1(b)(4).

[14] *See* 29 CFR § 2550.404a-1(c)(1), 85 Fed. Reg. 72846, 72884 (2020).

[15] 87 Fed. Reg. at 73870.

[16] *See* 29 CFR § 2550.404a-1(c)(2), 85 Fed. Reg. at 72884 (2020).

[17] *See* 87 Fed. Reg. at 73838

[18] 87 Fed. Reg. at 73871.

[19] 87 Fed. Reg. at 73831.

[20] *See Thole v. U.S. Bank, N.A*, 140 S. Ct. 1615 (2020), discussed in our prior blog post.

[21] *See* 87 Fed. Reg. at 73836.

[22] *See* 87 Fed. Reg. at 73860.

[23] *See* 29 CFR § 2550.404a-1(c)(3).

[24] 87 Fed. Reg. at 73842.

[25]*See id*.

[26] 29 CFR § 2550.404a-1(c)(2)(i)

[27] *See, e.g., Hughes v. Northwestern*, 142 S.Ct. 737, 742 (2022).

[28] 29 CFR § 2550.404a-1(c)(2)(i).

[29] 87 Fed. Reg. at 73832.

[30] *See* 87 Fed. Reg. at 73834.

[31] *Id*.

[32] *See* 87 Fed. Reg. at 73879.

[33] *See* 87 Fed. Reg. at 73838.

[34] *See* 87 Fed. Reg. at 73841.

[35] 87 Fed. Reg. at 73845.

[36] 87 Fed. Reg. at 73844.

[37] 87 Fed. Reg. at 73845.

[38] *See* 87 Fed. Reg. at 73844.

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